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| IN THE MATTER OF THE APPLICATION OF UNS GAS, INC. FOR THE ESTABLISHMENT OF JUST AND REASONABLE RATES AND CHARGES DESIGNED TO REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF THE PROPERTIES OF UNS GAS, INC. DEVOTED TO ITS OPERATIONS THROUGHOUT THE STATE OF ARIZONA CORPORATION COMMISSIONON. | DOCKET NO. G-04204A-06-0463 |
| IN THE MATTER OF THE APPLICATION OF UNS GAS, INC. TO REVIEW AND REVISE ITS PURCHASED GAS ADJUSTOR. | DOCKET NO. G-04204A-06-0013 |
| IN THE MATTER OF THE INQUIRY INTO THE PRUDENCE OF THE GAS PROCUREMENT PRACTICES OF UNS GAS, INC. | DOCKET NO. G-04204A-05-0831 |

Arizona Corporation Commission
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**STAFF'S OPENING BRIEF**

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## I. Introduction

UNS Gas is a public service corporation that provides natural gas distribution services to approximately 140,000 customers in Arizona. It was formerly part of the Arizona local gas distribution operations of Citizens Communications Company, prior to its 2003 acquisition by UniSource Energy. When UniSource Energy acquired the Arizona electric and gas assets from Citizens, it formed two operating companies – UNS Gas and UNS Electric.

UNS Gas is requesting a revenue increase of $9.647 million, or approximately 7 percent. Commission Staff's review of the Company's case indicates that the Company is entitled to only a $4.312 million increase on fair value rate base.[1]

The main areas of contention between the Company and Staff in this case relate to the Company's multi-pronged effort to shift as much risk to ratepayers as possible. The Company does this in several ways.

First, it tries to accomplish this risk shifting through its rate design proposals. A few notable examples are its proposals to introduce a new revenue decoupling mechanism and to increase the fixed customer charges, particularly for the residential class, to unprecedented and staggering levels. It proposes to introduce a revenue decoupling mechanism called a TAM which would adjust for variances in weather, economics and other factors, with adjustments to customer bills in order to guarantee the Company's revenue stream. It proposes to increase its fixed customer charge by 143% in the case of residential customers, while at the same time decreasing its per therm usage charge, a proposal which on its face looks very much like a straight-fixed-variable rate design and which flies in the face of the gradualism principle.

Second, this risk shifting strategy also takes the form of other proposals such as the Company's request to include Construction Work in Progress in rate base and to use a hypothetical capital structure. Each of these proposals, while appropriate in limited cases, is not appropriate in this case. Their use by the Company in this case has the effect of requiring rate payers to pay more than they should under normal and well-accepted rate-making principles, resulting in the rate payers

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[1] Staff Ex. 27 (Smith Surrebuttal) at p. 2. The comparable increase computed by applying Staff's recommended cost of capital to Staff's adjusted original cost rate base is $4.336 million.

insulating the Company from normal levels of risk and in rates designed to guarantee the Company's revenue stream.

Staff's recommendations, on the other hand, are based upon traditional and well-accepted rate-making principles which result in an equitable balance between rate payers and shareholders in this case.

## II. The Staff's Overall Revenue Requirement Was Calculated in Conformance with Prior Commission Decisions and is Supported by the Record in this Case

UNS Gas is requesting a revenue increase of $9.647 million, or approximately 7 percent. Staff's review of the Company's case indicates that the Company has proved up a case for a $4.312 million revenue increase only, based upon a historic test year ended December 31, 2005.[2]

### A. Staff's Adjustments to Rate Base are Reasonable and Should be Adopted by the Commission

The Company's proposed rate base computed on both an Original Cost and Fair Value basis respectively are as follows: $161,661,361.00 and $191,177,715.00.[3] Staff's proposed rate base computed on both an Original Cost and Fair Value basis respectively are as follows: $154,541,358.00 and $184,057,712.00.[4] These amounts were updated in Staff's Surrebuttal Testimony to $154,547,272.00 and 184,063,625.00, respectively.[5] The difference between the Company's and Staff's proposed rate bases is $7,114,089.00 and is due to the following major differences between Staff and the Company.

#### 1. Construction Work in Progress

UNS Gas proposes to include $7.189 million of Construction Work in Progress ("CWIP") in rate base.[6] Staff removes the proposed CWIP in rate base in this case because the Commission's general practice is not to allow CWIP to be included in rate base.[7]

The Company argues that it is necessary to include CWIP in rate base to preserve the financial integrity of the Company.[8] UNS Gas Witness Kentton Smith also argues that inclusion of

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[2] Staff Ex. 25 (Smith Direct) at p. 4; Staff Ex. 27 (Smith Surrebuttal) at 2.
[3] Staff Ex. 25 (Smith Direct) at p. 7.
[4] *Id.*
[5] Staff Ex. 27 (Smith Surrebuttal), Attachment RCS-2S, Schedule B, page 1 of 2.
[6] Staff Ex. 25 (Smith Direct) at p. 7.
[7] Staff Ex. 25 (Smith Direct) at p. 8.

CWIP will help mitigate the effects of regulatory lag.[9] He argues that if the Commission does not include CWIP in rate base, the authorized rate of return should be increased, and the Commission should consider an adjustment for plant placed into service after the test year.[10]

Staff Witness Ralph Smith provided testimony in this case on the Company's proposed revenue requirement, including rate base additions, operating income, expense calculations and rate design. Mr. Smith is both a CPA and an attorney with extensive experience in the utility regulatory area. He is a Senior Regulatory Consultant at Larkin & Associates, PLLC.[11] Mr. Smith testified that inclusion of CWIP in rate base is an exception to the Commission's normal practice.[12] And, the Company has not met its burden of proof to justify the exceptional treatment it is requesting.

The Company's argument that it will be imperiled financially if CWIP is not included is not persuasive. Staff's cost of capital expert, Mr. David Parcell testified that he did not believe that it was necessary to provide CWIP treatment in order for UNS Gas to attract capital.[13] The following is an excerpt from his Direct Testimony on this point:

> As I indicated above, the rating agencies describe the operations of UNS Gas as low risk. It is further apparent that UNS Gas receives its financing based on the credit quality of UniSource Energy and/or UES, not based on the situation of the Company itself. In summary, I do not believe it is necessary for UNS Gas to receive CWIP treatment in order for it to attract capital.[14]

UNS Gas also accrues a return on construction projects, representing its financing costs, during the construction period.[15] This is called Allowance for Funds Used During Construction ("AFUDC").[16] When the plant is placed into service, the AFUDC becomes part of the cost of the plant and is depreciated.[17]

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[8] *Id.*
[9] *Id.*
[10] *Id.*
[11] Staff Ex. 25 (Smith Direct) at p. 1.
[12] Staff Ex. 25 (Smith Direct) at p. 9.
[13] Staff Ex. 25 (Parcell Direct) at 17.
[14] Staff Ex. 25 (Parcell Direct) at 17.
[15] Staff Ex. 25 (Smith Direct) at 11.
[16] *Id.*
[17] *Id.*

Another well-established rate-making principle which supports the exclusion of CWIP from rate base is that CWIP was not in service at the end of the test year,[18] and therefore, it was not used and useful to ratepayers during the test year. Further, to include CWIP would violate the "matching" principle. It would result in a mismatch between revenue and rate base. When the plant is placed into service, the Company also receives revenues from customers. It may also experience some cost reductions.[19] For instance, the Company could experience a reduction to maintenance expenditures which would not be reflected in the test period.[20] Eventually, the plant is included in rate base at the Company's next rate case, and rates are reset and the Company earns a cash return on the plant investment, less accumulated depreciation.[21]

Alternatively, the Company proposes that the Commission include post-test year plant additions in rate base, if the inclusion of CWIP in rate base is denied. Staff also opposes the inclusion of post-test year plant in rate base since it suffers from the same flaws as the Company's proposal to include CWIP in rate base.[22] It is imbalanced since it fails to recognize any post-test year revenue growth and maintenance expense decreases which result from the new plant's additions.[23]

Finally, the Commission should also reject Mr. Grant's recommendation to remove approximately $4.158 million of Customer Advances from the rate base calculation, if CWIP is excluded. As Mr. Smith testified, customer advances represent non-investor supplied capital and should be reflected as a deduction to rate base.[24] Mr. Grant has not cited any prior decision to support the Company's position.

Nor is Staff aware of an instance for any major Arizona public utility where CWIP was excluded from rate base and Customer Advances were not reflected as a deduction to rate base. The Commission's rules (A.A.C. R14-2-103, Appendix B, Schedule B-1) require that Customer Advances be reflected as a deduction from rate base.

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[18] Staff Ex. 25 (Smith Direct) at p.9.
[19] Id.
[20] Staff Ex. 25 (Smith Direct) at p. 10.
[21] Staff Ex. 25 (Smith Direct) at 11.
[22] Staff. Ex. 27 (Smith Surrebuttal) at 14.
[23] *Id.*
[24] Staff Ex. 27 (Smith Surrebuttal) at 15.

One additional reason why Customer Advances should be deducted from rate base is to prevent a double rate of return. In accruing AFUDC by applying the AFUDC rate to a CWIP balance, Customer Advances are typically not deducted from the construction cost base upon which AFUDC is computed. If the Customer Advances have not been specifically deducted in the AFUDC calculations (which would be contrary to the prescribed treatment for a utility following the AFUDC formula in the FERC Uniform System of Accounts), the non-investor provided cost-free capital in the form of Customer Advances needs to be reflected as a rate base deduction. Consequently, the request by Company Witness Grant to adjust the balance of Customer Advances, if CWIP is excluded from rate base, is contrary to precedent, would be improper for ratemaking purposes, and should be rejected.

The Commission should reject the Company's request to include CWIP in rate base in this case, or in the alternative, to recognize post-test year plant additions to rate base. The Company's related adjustments to increase depreciation and property taxes relating to the inclusion of CWIP in rate base should also be rejected.

### 2. Global Information System (GIS) Deferral

The Company has proposed to include approximately $897,068 in rate base as a deferral for GIS, and to prospectively amortize the deferred cost over a three-year period.[25] Mr. Smith testified that during 2003-2005, UNS Gas undertook a project to locate and assign global positioning system (GPS) information to its existing service lines in order to update the UNS Gas GIS.[26] The project was undertaken as a result of a Commission compliance audit which found that: "Maps available at the time of the audit and used by locating, leak survey, construction and emergency personnel fail to include all service lines."[27] GIS helps the Company maintain an accurate, up-to-date record of its facilities.[28]

[25] Staff Ex. 25 (Smith Direct) at 12.
[26] Staff Ex. 25 (Smith Direct) at 14.
[27] *Id.*
[28] Ex. A-25 (Smith Direct) at

It is Staff's position that these costs should not be included in rate base for the test year. These costs are non-recurring expenses that were largely incurred prior to the test year.[29] UNS Gas failed to request an accounting order for Commission authorization of deferral of such costs when they were being incurred.[30] UNS Gas should not be able to come in now and request retroactive approval of the GIS costs as a "regulatory asset" to be included in rate base and amortized prospectively in customer rates.[31]

Moreover, Staff Witness Ralph Smith explained why inclusion of GIS costs as an asset in rate base is not appropriate under Generally Accepted Accounting Principles as well as generally accepted ratemaking principles:

> ...Under Generally Accepted Accounting Principles ("GAAP"), such costs were required to be expensed in the period incurred. The company had initially applied a capitalization treatment of such costs, but determined that that was an error and a violation of GAAP, and has recorded an entry on its books to expense such costs. For accounting purposes, the GIS costs are expenses, not an investment. The appropriate treatment for non-recurring expenses, especially ones relating to periods prior to the test year and for which deferral for accounting purposes was not pre-approved, is to exclude them from rates. Staff's proposed treatment does this.[32]

The Company's own internal documentation obtained by Staff during discovery indicate that the Company initially decided to treat GIS as an "investment" or asset but later determined that capitalization would be inappropriate under GAAP.[33]

The Company seems to believe that it is somehow disadvantaged by its inability to recoup this expense as part of the 2005 test year. However, it is not at all uncommon or unusual for a utility's investors to be responsible for expenses which occur in between rate cases and to be responsible for expenses which are incurred outside of a test year. As Staff Witness Ralph Smith pointed out in his Rebuttal Testimony, the flip-side to this is that the utility's investors also benefit from cost decreases and increased revenues that occur between rate cases.[34]

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[29] Staff Ex. 26 (Smith Surrebuttal) at 16.
[30] Staff Ex. 26 (Smith Surrebuttal) at p. 16.
[31] Staff Ex. 26 (Smith Surrebuttal) at p. 16.
[32] Staff Ex. 26 (Smith Surrebuttal) at p. 16.
[33] Staff Ex. 26 (Smith Surrebuttal) at p. 18.
[34] *Id.*

The Company's proposal to include deferred GIS costs as a "regulatory asset" in rate base should be rejected for the reasons provided by Staff Witness Smith. The Company's related proposal for prospectively charging ratepayers for an amortization of such expenses should also be rejected.

### 3. Cash Working Capital

Staff Witness Ralph Smith explained the concept of "Cash Working Capital" in his Direct Testimony as follows:

> Cash working capital is the cash needed by the Company to cover its day-to-day operations. If the Company's cash expenditures, on an aggregate basis, [35]precede the cash recovery of expenses, investors must provide cash working capital. In that situation a positive cash working capital requirement exists. On the other hand, if revenues are typically received prior to when expenditures are made, on average, then ratepayers provide the cash working capital to the utility, and the negative cash working capital allowance is reflected as a reduction to rate base. In this case, the cash working capital requirement is a reduction to rate base as ratepayers are essentially supplying these funds.[36]

Mr. Smith testified that UNS Gas has a negative cash working capital requirement which means that ratepayers are essentially supplying the funds used for the day-to-day operations of the Company. While UNS Gas performed a lead/lag study, Staff's calculations show that the Company's proposed working capital of negative $1.045 million should be increased to negative $268,272.[37]

### 4. Accumulated Deferred Income Tax (ADIT)

Due to the above adjustments, Staff further adjusted rate base by $195,336 to account for the following:

1) removal of the ADIT related to the GIS deferral that UNS Gas added to rate base that was removed by Staff;

2) removal of the ADIT related to the Supplemental Executive Retirement Plan (SERP); and

3) removal of 50% of the ADIT related to incentive compensation.[38]

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[35] Staff Ex. 25 (Smith Direct) at p. 18.
[36] Ex. S—25 (Smith Direct0 at 18.
[37] Staff Ex. S-27 (Smith Surrebuttal), Attachment RCS-2S, Schedule B, page 1.
[38] Ex. S-25 (Smith Direct) at 19.

UNS presented no rebuttal contesting these adjustments. These adjustments to ADIT are necessary to properly coordinate the rate base with the components of net operating income and should be adopted.

**B. Staff's Adjustments to Operating Income are Reasonable and Should be Adopted by the Commission**

**1. Revenue Annualization**

The revenue annualization adjusts revenues to reflect the growth in customers that occurred throughout the test year.[39] Staff utilized the "traditional approach" in calculating customer revenue annualization. Staff's revenue annualization resulted in $102,433 more gas revenue (excluding purchased gas) than did the revenue annualization proposed by UNS Gas. Staff thus adjusted the Company's operating income accordingly.[40]

Under the traditional approach, Staff calculated the difference between actual December 2005 customers, by rate class, and the number of customers in each of the other months of the test year. The change in customers to an annualized year-end level was then multiplied by the customer charge and margin amounts applicable to that rate class. Staff used the same customer charge and margin amounts used by UNS Gas.[41]

However, the Company claims that Staff's use of the "traditional approach" in this case was inappropriate. Staff disagrees. As Staff Witness Smith testified, the traditional method of customer annualization has been effective in coordinating the revenue element of the ratemaking formula with the other components, such as rate base.[42] Many of the arguments raised by UNS Gas against its use in this case have no merit. In addition, any method for determining an appropriate annualization adjustment should be straight-forward and transparent so as to allow others to replicate and verify its results.[43] The traditional approach meets these criteria. The Company's approach which applied

[39] *Id.*
[40] Ex. S-25 (Smith Direct) at 20.
[41] *Id.*
[42] Ex. S-27 (Smith Surrebuttal) at 21.
[43] *Id.* at 24.

percentage "growth factors" instead of customer bill counts, were very difficult to follow and replicate and appear to actually understate growth.[44]

### 2. Weather Normalization

Staff's weather normalization adjustment increases retail revenue by $1,962. Staff's adjustment varies from the weather normalization adjustment proposed by UNS Gas because the weighted average number of customers, in Staff's annualization, exceeded the corresponding level reflected in UNS Gas' corresponding annualization. Both the Staff and the UNS Gas weather normalization adjustments reflect an increase to revenue because the test year was warmer than normal.[45]

### 3. Adjustment to Bad Debt Expense

The differences in Bad Debt Expense between Staff and UNS Gas relate not to the calculation method, but rather are driven by the impact of the revenue adjustments. UNS Gas Witness Mr. Dukes stated at page 2 of his Rebuttal Testimony that the differences in Bad Debt Expense between UNS Gas and Staff result from the different customer annualization and weather normalization adjustments, and, other than that, UNS Gas and Staff are basically in agreement on the calculation.[46]

### 4. Depreciation and Property Taxes for CWIP

This adjustment removes the pro forma amounts calculated by UNS Gas for depreciation and property taxes related to the Company's proposal to include CWIP in rate base. As explained above, Staff disagrees with the Company's proposal to include CWIP in rate base, and the Company's alternative proposal to include post-test year plant in rate base.[47]

### 5. Amortization of Deferred GIS Cost

This adjustment removes the Company's proposed amortization of $299,023. During 2004-2005, UNS undertook a project to locate and assign global positioning system (GPS) information to

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[44] *Id.* at 24.
[45] Ex. S-27 (Smith Surrebuttal) .
[46] Ex. S-27 (Smith Surrebuttal).
[47] Ex. S-27 (Smith Surrebuttal .

its existing service lines in order to update the UNS Gas GIS. Part of the basis for this request by the Company is that the project has a benefit to future periods. However, these expenses largely were incurred in prior periods and are nonrecurring. Without seeking Commission pre-approval, UNS Gas is now requesting deferral treatment for costs that should have been expensed in periods prior to the test year. Staff disagrees with the Company's proposal to amortize such costs prospectively over a three-year period.[48]

### 6. Incentive Compensation and Supplemental Executive Retirement Program

Staff adjusted the Company's expenses associated with various incentive compensation plans, including the Performance Enhancement Plan ("PEP"). Staff adjusted the amount of the expense related to almost all of these programs by 50%.[49] Incentive compensation programs benefit both shareholders and ratepayers. The removal of 50% of the expense related to such programs provides an equal sharing of the cost of such programs between shareholders and ratepayers, since the programs benefit both groups.[50]

Staff also removed 100% of the expense associated with the Supplemental Executive Retirement Plan (SERP).[51] This plan provides supplemental retirement benefits for select executives of UNS Gas.[52] SERPs typically provide for retirement benefits in excess of the limits placed by IRS regulations on pension plan calculations for salaries in excess of specified amounts.[53]

Staff's adjustments are consistent with the Commission's recent decision in the last Southwest Gas rate case. In the Southwest Gas case, the Commission adopted Staff's recommendation for an equal sharing of incentive compensation plan costs and RUCO's recommendation to remove SERP expense in its entirety. In the following passage from that Order, the Commission addressed the removal of SERP expense:

> Although we rejected RUCO's arguments on this issue in the Company's last rate proceeding, we believe that the record in this case supports a finding that the provision of additional compensation to

[48] Ex. S-25 (Smith Direct) at Ex. S-27
[49] Ex. S-25 (Smith Direct) at 23.
[50] *Id.*
[51] *Id.*
[52] Ex. S-25 (Smith Direct) at 24.
[53] *Id.*

> Southwest Gas' highest paid employees to remedy a perceived deficiency in retirement benefits relative to the company's other employees is not a reasonable expense that should be recovered in rates. Without the SERP, the Company's officers still enjoy the same retirement benefits available to any other Southwest Gas employee and the attempt to make these executives 'whole' in the sense of allowing a greater percentage of retirement benefits does not meet the test of reasonableness. If the Company wishes to provide additional retirement benefits above the level permitted by IRS regulations applicable to all other employees it may do so at the expense of its shareholders. However, it is not reasonable to place this additional burden on ratepayers.[54]

The Company has not presented any rationale or support for the Commission to treat its incentive compensation plans differently for ratemaking purposes than the Commission's treatment of similar plans in the last Southwest Gas rate case.

7. **Emergency Bill Assistance Expense**

UNS Gas has accepted this Staff adjustment, which increases test year expense to be included in the base rate revenue requirement determination by $21,600 to provide for an increase requested by the Company for emergency bill assistance.

8. **Overtime Payroll Expense**

Staff proposed an adjustment to reduce the Company's proposed amount of test year overtime payroll expense by $123,010.[55] At Page 17 of his Rebuttal Testimony, Mr. Dukes indicates that he agrees with this Staff adjustment, which reduced the amount of pro forma expense in the Company's payroll adjustment, because it is more reflective of the expected overtime levels that should be included in rates.

9. **Payroll Tax Expense**

Staff proposes reducing the pro forma payroll tax expense in UNS Gas' filing by $9,348 to reflect the Staff adjustments to overtime payroll and incentive compensation expense.[56]

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[54] Decision No. 68487 at 19.
[55] Ex. S-25 (Smith Direct).
[56] Ex. S-27 (Smith Surrebuttal).

### 10. Nonrecurring FERC Rate Case Legal Expense

The Staff also made an adjustment to normalize legal expenses for the test year. As explained by Staff Witness Ralph Smith, during the 2005 test year, UNS Gas incurred substantial legal expenses related to settlement discussions in the El Paso Natural Gas rate case at the Federal Energy Regulatory Commission ("FERC").[57] That case ultimately settled. The associated expenses included by UNS Gas amounted to $311,051. Since they are nonrecurring, they should be removed.[58]

### 11. Property Tax Expense

This adjustment is necessary to reflect the known statutory assessment ratio of 24 percent applicable for 2007. The Arizona State Legislature passed House Bill No. 2779 which set a new rate schedule for property tax assessments. The new assessment rate schedule provides for decreasing the 25 percent rate applicable in 2005 in 0.5 percent steps each year until a 20 percent rate is attained in 2015. The Company's calculation used a 24.5 percent assessment rate and thus fails to recognize the impact of this known tax change prospectively.

The current assessment rate in 2007 is 24%. Staff concluded that since the Commission approved rates are expected to become effective in mid-2007, and the Company's anticipated rate case interval is three years, as evidenced by the Company's proposed normalization period for rate case expense, the property tax rate that will be in effect for 2007 of 24% is appropriate.[59]

In terms of determining the recommended assessment rate, Staff compared its recommendation in the current UNS Gas rate case with a similar determination in the recent Southwest Gas rate case. In the Southwest Gas case, Southwest Gas, Staff and RUCO all ultimately agreed on the appropriateness of using a 24.5% assessment rate effective for 2006 in conjunction with the test year in that case ending August 31, 2004. As explained in Staff Witness Smith's Direct and Surrebuttal Testimony, the appropriateness of using the known 24% assessment rate in the current UNS Gas rate case is supported by the comparison with Southwest Gas.

### 12. Workers Compensation Expense

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[57] Ex. S-25 (Smith Direct) at 30.
[58] *Id.*
[59] Ex. S-27 (Smith Surrebuttal).

UNS Gas has accepted Staff's adjustment, which reversed a UNS Gas' proposed adjustment to increase test year expense for using a cash basis, rather than an accrual accounting basis, for recognizing worker's compensation expenses for ratemaking purposes.

### 13. Membership and Industry Association Dues

Staff removed 40% of UNS Gas' 2005 American Gas Association ("AGA") dues for 2005, which were $41,854.00. Staff also removed other discretionary membership and industry association dues which are not needed for the "safe and reliable provision of gas utility service."[60]

Staff's proposed disallowance is reasonable for several reasons. First, according to NARUC sponsored audits of 1999 AGA expenditures, "...these expense categories may be viewed by some State commissions as potential vehicles for charging ratepayers with such costs as lobbying, advocacy or promotional activities which may not be to their benefit."[61] Second, from the latest NARUC Audit Report on AGA expenditures that Staff was able to locate dated June 2001, for the twelve-month period ended December 31, 1999, it appears that 41.65% of 1999 AGA expenditures related to lobbying and advertising.[62]

The total amount of test year expense for membership dues removed by Staff was $26,868.[63]

### 14. Fleet Fuel Expense

Staff and UNS Gas are in agreement concerning the necessary adjustment for fleet fuel expense. Staff revised its originally proposed adjustment to reflect the amount shown in UNS Gas' Rebuttal testimony. This adjustment reduces operating expense in UNS Gas' original filing by $12, 657.[64]

### 15. Postage Expense

Staff's revised postage expense adjustment used a starting point of $445,171 for the adjustment calculation. Staff witness Smith accepted $445,171 as the appropriate starting point for

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[60] Ex. S-25 (Smith Direct) at 35.
[61] *Id.* at 36.
[62] *Id.*
[63] *Id.* at 38.
[64] Ex. S-27 (Smith Surrebuttal), Attachment RCS-2S, Schedule C-15.

the calculation, as discussed in UNS Gas witness Dukes' rebuttal testimony at pages 19-20. This produces an annualized postage expense of $476,960. An annualized postage expense of $476,960 properly recognizes the postage expense increase that occurred on January 8, 2006 and the customer growth that occurred during the 2005 test year. Staff also reflected the known and measurable May 14, 2007 postage increase that raised the cost of a first class letter from $0.39 to $0.41. Staff recommends allowing annualized postage expense of $503,356. The adjustment to the $529,380 amount in the UNS Gas filing would be a decrease of $26,024.[65]

At page 20 of his rebuttal testimony, Mr. Dukes referenced what he called a "known and measurable" amount of postage expense for 2006 and suggests that, because of that 2006 expense, the Company's originally proposed postage request of $529,380 should be used. The 2006 postage expense amount would reflect customer growth beyond the end of the test year, and the related revenues resulting from such customer growth beyond the end of the test year have not been reflected. Customer growth has only been reflected through December 31, 2005, the end of the test year. Reflecting increased postage expense related to post-test year growth in the number of customers without reflecting the related additional revenues is inappropriate and should be rejected.[66]

### 16. <u>Interest Synchronization</u>

This adjustment decreases income tax expense by the amount shown on Ex-27 (Smith Surrebuttal) Attachment RCS-2S, Schedule C-17 and increases the Company's achieved operating income by a similar amount. It is necessary to coordinate the income tax calculation with the rate base and cost of capital. UNS Gas and Staff are in agreement on the methodology for calculating the adjustment.

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[65] Ex S-26 (Smith Surrebuttal).
[66] Ex S-26 (Smith Surrebuttal).

### 17. Corporate Cost Allocations

RUCO discovered some additional non-recurring charges related to an attempted merger and has correctly proposed to remove such costs. UNS Gas and Staff agreed with that RUCO adjustment which reduces expense by $12,765.[67]

### 18. Rate Case Expense

Staff proposes a rate case expense allowance of $85,000.00 per year, based on a total of $255,000 normalized over three years.[68] RUCO proposed an allowance of $83,667 per year, based on limiting the total amount to $251,000 over three years. The amount requested by UNS Gas for rate case expense is 3.8 times as high as the amount of rate case expense allowed by the Commission in the Southwest Gas rate case. While Southwest Gas is a larger utility than UNS Gas, the scope of the issues were similar.

While the current case may be the first rate case for this utility operation under its current ownership, it is not the first rate case for this utility. This gas utility had periodic, recurring rate cases under its prior ownership by Citizens Utilities. The transfer of ownership should not be an excuse for charging ratepayers for what appear to be excessive amounts of rate case cost.

Moreover, the current UNS Gas rate case is similar to and presents many of the same issues, such as a proposed revenue decoupling mechanism, revisions to the PGA mechanism, etc., that were recently addressed by the Commission in Docket No. G-01551A-04-0876, a rate case involving the other large gas distribution utility in the state, Southwest Gas Corporation. Staff believes that the Southwest Gas case provides a reasonable benchmark for what a reasonable allowance for rate case cost should be in the current UNS Gas rate case.

### 19. CARES Related Amortization

Staff recommends that UNS Gas cease deferral of costs related to the CARES program effective with the date for new rates established in this case. Staff has recognized CARES program discounts in Staff's proposed rate design. Staff also recognizes that UNS Gas has accumulated some

[67] Ex S-26 (Smith Surrebuttal).
[68] Ex S-26 (Smith Surrebuttal) .

deferred costs related to the CARES program. Staff witness Ms. McNeely-Kirwan presented the recommendation concerning how those accumulated deferred CARES costs should be amortized for ratemaking purposes. Staff's adjustment reduces the operating expense in UNS Gas' filing by $441,511.

**20. <u>Nonrecurring Severance Payment</u>**

Staff had proposed, but withdrew, and adjustment to remove a nonrecurring severance expense related to a UNS Gas employee.[69] Staff disagrees with the attempt by UNS Gas that was presented in the Company's rebuttal testimony of Mr. Dukes to revise its filing to add this nonrecurring severance expense back twice.[70]

**21. <u>Depreciation Rates</u>**

Staff is in agreement with the Company's proposed new depreciation rates.[71] On December 31, 2005 plant investment, the difference between the current and proposed new depreciation rates produce a decrease in annualized depreciation expense for the Company of $610,980.00.[72] However, Staff Witness Smith recommended that each of the new depreciation rates proposed by UNS Gas should be clearly broken out between (1) a service life rate and (2) a net salvage rate. Staff Witness Smith explained that by doing this, the depreciation expense related to the inclusion of estimated future cost of removal in depreciation rates can be tracked and accounted for by plant account.[73]

**22. <u>Depreciation Rates</u>**

Staff is in agreement with the Company's proposed new depreciation rates.[74] On December 31, 2005 plant investment, the difference between the current and proposed new depreciation rates produce a decrease in annualized depreciation expense for the Company of $610,980.00.[75] However,

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[69] Ex S-26 (Smith Surrebuttal).
[70] Ex S-26 (Smith Surrebuttal).
[71] Ex. S-25 (Smith Direct) at 63.
[72] Ex. S-25 (Smith Direct) at 39.
[73] Ex. S-25 (Smith Direct) at 63.
[74] Ex. S-25 (Smith Direct) at 63.
[75] Ex. S-25 (Smith Direct) at 39.

Staff Witness Smith recommended that each of the new depreciation rates proposed by UNS Gas should be clearly broken out between (1) a service life rate and (2) a net salvage rate. Staff Witness Smith explained that by doing this, the depreciation expense related to the inclusion of estimated future cost of removal in depreciation rates can be tracked and accounted for by plant account.[76]

### C. <u>Staff's Cost of Capital Determination is Supported by the Record and Should be Adopted by the Commission</u>

Staff Witness Parcell presented the Staff's position on cost of capital in this case. Mr. Parcell holds a B.A. and M.A. degrees in economics from Virginia Polytechnic Institute and State University (Virginia Tech) and a M.B.A. from Virginia Commonwealth University. He has been a consulting economist with Technical Associates since 1970 and has filed testimony and/or testified in over 375 utility proceedings before about 35 regulatory agencies in the United States and Canada.

Mr. Parcell recommended using the actual capital structure of the Company which consists of 55.33% long-term debt and 44.67% equity. Mr. Parcell recommended a long-term debt rate of 6.6%. He recommended a cost of equity of 10.0 percent (the midpoint between 9.5% and 10.5%). This equated to an overall cost of capital recommendation for UNS Gas of 8.12%.

There are two areas of disagreement between the Company and Staff. The Staff and the Company are in agreement on 6.6% cost of debt. The first area of disagreement is the capital structure for UNS Gas and the second area of disagreement is with the cost of equity. The Company is proposing a hypothetical capital structure in this case of 50% equity and 50% long-term debt. Because the actual equity ratio of the Company is 44.6%, use of the Company's recommended hypothetical capital structure would increase the actual return on equity to a level exceeding that intentionally approved by the Commission.[77]

Staff Witness Parcell actually demonstrated that use of the Company's recommended hypothetical capital structure would be the equivalent of giving the Company an 11.5% return on equity using its actual capital structure, which would be excessive in this case.[78]

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[76] Ex. S-25 (Smith Direct) at 63.
[77] Ex. S-36 (Parcell Direct) at 20.
[78] Ex. S-36 (Parcell Direct) at 21.

Hypothetical Capital Structure

| | Percent | Cost | Wgt. Cost |
|---|---|---|---|
| Debt | 50% | 6.6% | 3.65% |
| Equity | 50% | 11.0% | 5.15% |
| Total | | | 8.80% |

Actual Capital Structure

| | Percent | Cost | Wgt. Cost |
|---|---|---|---|
| Debt | 55.33% | 6.6% | 3.65% |
| Equity | 44.67% | 11.5% | 5.15% |
| | | | 8.80% |

The use of a hypothetical capital structure would have the impact of increasing the actual return on equity by 50 basis points.[79] This is just another means of adjusting for risk; which is not necessary because Staff has already included an appropriate risk adjustment given the Company's actual capital structure. If a hypothetical structure is used, Staff's return on equity would overestimate the Company's risk.

The cost of equity is typically the most contentious part of the overall weighted cost of capital determination. Mr. Parcell utilized methodologies well accepted by the industry and two of which have been extensively utilized by this Commission in the past: the Discounted Cash Flow Model (DCF"), the Capital Asset Pricing Model ("CAPM") and the Comparable Earnings Method ("CE").

Since UNS Gas is not a publicly-traded company, it is not possible to directly apply cost of equity models to this entity.[80] While its parent, UniSource Energy, is publicly-traded, the parent's recent financial situation and diversified nature make its results of limited value.[81] Thus, Mr. Parcell used 2 groups of comparison or "proxy" companies as a substitute for UNS Gas to determine its cost of equity.[82]

The two sample groups chosen by Mr. Parcell consisted of the following: 1) a group of nine combination electric and gas companies and 2) a group of 11 natural gas utilities used by UNS Gas witness Grant in his cost of capital analysis.[83]

[79] Ex. S-36 (Parcell Direct) at p. 21.
[80] Ex. S-36 (Parcell Direct) at p. 23.
[81] Ex. S-36 (Parcell Direct) at p. 23.
[82] Ex. S-36 (Parcell Direct) at p. 23.
[83] Ex. S-36 (Parcell Direct) at p. 23.

The first model utilized by Mr. Parcell was the DCF model which was described in the following passage from Mr. Parcell's Direct Testimony:

> The discounted cash flow model is one of the oldest, as well as the most commonly-used, models for estimating the cost of common equity for public utilities. The DCF model is based on the 'dividend discount model' of financial theory, which maintains that the value (price) of any security or commodity is the discounted present value of all future cash flows.[84]

Based upon Mr. Parcell's analysis, a range of 9.25% to 10.5% was found to represent the current DCF cost of equity for the proxy groups.[85]

Staff Witness Parcell then utilized the CAPM model which describes and measures the relationship between a security's investment risk and its market rate of return.[86] Mr. Parcell's CAPM results indicate a cost of equity between 9.5% and 10.25%.[87]

While not utilized or relied upon by this Commission extensively in the past, Mr. Parcell also conducted a Comparable Earnings analysis.[88] The CE method is designed to measure the returns expected to be earned on the original cost book value of similar risk enterprises.[89] Staff Witness Parcell further elaborated on this method in his prefiled testimony:

> It is generally recognized for utilities that market-to-book ratios of greater than one (i.e. 100%) reflect a situation where a company is able to attract new equity capital without dilution of book value. As a result, maintenance of a stock price above book value is one measure of the fairness of a utility's authorized cost of equity.[90]

Staff Witness Parcell also explained that his CE analysis was based upon market data (through the use of market-to-book ratios) and is thus essentially a market test, which makes it less susceptible to the criticisms occasionally made by some who argue that past earned returns do not represent the cost of capital.[91] Based upon recent earnings and market-to-book ratios, Mr. Parcell's CE analysis yielded a cost of equity for the proxy utilities of no more than 10%.[92]

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[84] Ex. S-36 (Parcell Direct) at p. 25.
[85] Ex. S-36 (Parcell Direct) at p. 25.
[86] Ex. S-36 (Parcell Direct) at p. 28.
[87] Ex. S-36 (Parcell Direct) at p. 28.
[88] Ex. S-36 (Parcell Direct) at p. 31.
[89] Ex. S- 36 (Parcell Direct) at p. 31.
[90] Ex. S- 36 (Parcell Direct) at p. 31.
[91] Ex. S-36 (Parcell Direct) at p. 32.
[92] Ex. S-36 (Parcell Direct) at p. 33.

To summarize, Mr. Parcell's results under the three methods are as follows:

| | |
|---|---|
| Discounted Cash Flow | 9.25-10.5% (9.88% mid-point) |
| Capital Asset Pricing Model | 9.5-10.25% (9.88% mid-point) |
| Comparable Earnings | 10.0% |

The resulting total cost of capital is a range of 7.89% to 8.34%, with a mid-point of 8.12%. Staff Witness Parcell's overall recommendation on total cost of capital is the mid-point of this range or 8.12%.[93]

Company Witness Grant's recommendation of a 11.0% cost of common equity is based upon the following:

| | Range | Median |
|---|---|---|
| DCF | 9.1-10.5% | 9.9% |
| CAPM | 9.9-11.7% | 11.0% |

Mr. Grant's recommendation of 11.0%, represents the highest median of his two analyses. There are also concerns with his risk-free rate and his risk premium inputs. His 5.3% risk free rate is out-dated[94] Mr. Grant also made an adjustment for the size of UNS Gas which was not appropriate.[95]

In his Rebuttal testimony, UNS Gas Witness Grant also relies upon a recent decision (unpublished) by the Arizona Court of Appeals involving Chaparral City Water Company to suggest the Commission simply apply the weighted cost of capital (or overall rate of return) to the Company's fair value rate base for purposes of setting rates in this proceeding.[96] While this decision is still being evaluated by the Staff, Staff does not agree with the Company's interpretation of the Chaparral City Water Company case as set forth in Mr. Grant's Rebuttal Testimony.

First, Mr. Grant must have missed page 13 of that decision wherein the Court of Appeals, stated the following, "the Commission asserts that it was not bound to use the weighted average cost of capital as the rate of return to be applied to the FVRB. The Commission is correct." In other words, the Court stated that the Commission is not bound to do exactly what Mr. Grant is suggesting the Commission do in the UNS Gas case. At page 13 of the decision, the Court also stated "if the

[93] Ex. S-36 (Parcell Direct) at p. 36.
[94] Ex. S-36 (Parcell Direct) at p. 37.
[95] Ex. S-36(Parcell Direct) at p. 38.
[96] Ex. UNSG (Grant Rebuttal) at 28.

Commission determines that the cost of capital analysis is not the appropriate methodology to determine the rate of return to be applied to the FVRB, the Commission has the discretion to determine the appropriate methodology."

Second, the methodology advocated by Mr. Grant would result in an unreasonable and excessive return on equity to the Company, for the reasons discussed in Mr. Parcell's testimony.[97] Mr. Parcell testified that based upon over 35 years of providing cost of capital testimony, the entire concept of cost of capital is designed to apply to an original cost rate base.[98] He further testified that when the concept of fair value rate base is incorporated, the link between rate base and capital structure is broken, in the following manner:[99]

> The 'excess' of fair value rate base over original cost rate base is not financed with investor-supplied funds and, indeed, the excess is not financed at all. As a result, the cost of capital cannot be applied to the fair value rate base since there is no financial link between the two concepts.[100]

While Staff is still reviewing the Court decision, Mr. Parcell offers a solution which recognizes this difference, which the Company's analysis has overlooked. Since the differential between fair value rate base and original cost rate base is not financed with investor-supplied funds, it is appropriate to attribute no cost to this 'excess' amount.[101] Such an analysis provides for a return being earned on all investor-supplied funds which is consistent with sound financial and regulatory standards.[102]

## IV. The Commission should reject the Company's Proposed Rate Design Because it Violates the Principle of Gradulism and its Front End Loading Represents a Drastic Shift Toward a Straight-Fixed-Variable Rate Design.

Like the majority of the Company's proposals in this case, the Company's rate design proposal is designed to shift almost all risk to rate-payers in the future. Rate design issues were addressed by Staff Witness Steven Ruback, who is a lawyer and engineer with more than 25 years of

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[97] Ex. S-27 (Smith Surrebuttal) at 5.
[98] Ex. S-37 (Parcell Surrebuttal) at 8.
[99] *Id.*
[100] *Id.* at 9.
[101] Ex. S-37 (Parcell Surrebuttal) at 9.
[102] *Id.*

experience as a rate consultant primarily in the gas and electric industries.[103] His principle areas of concentration are: 1) cost allocation studies; 2) class revenue requirements; 3) rate design; 4) unbundling; 5) transportation issues; 6) competition; 7) restructuring; 8) design day forecasting; 9) gas supply; 10) PGA and procurement issues; 11) hedging; and 12) related policy issues.[104]

Most notable about the Company's proposal is a "staggering" increase in the fixed customer charges for all classes of service.[105] Mr. Ruback testified that the most extreme customer charge proposed by the Company, however, is for the Residential class, which the Company proposes to increase by 185% during the summer period and 57% during the winter period.[106] But other classes would also experience sharp customer charge increases.[107]

According to Mr. Ruback, the Company's proposal presents a serious front end loading problem, a decoupling issue and a gradualism problem, especially with respect to the Residential class.[108] That class alone would see their customer charge increase by approximately 143%.[109] Put another way, the Company is proposing to collect an increase of $14.6 million in the Residential R-10 rate class under its proposed customer charges, but the Company is only requesting a total increase of $6.58 million for the Residential class.[110] Mr. Ruback testified that "[i]ncreasing the customer charges to provide more revenue than the proposed revenue increase requires that existing volumetric rates be reduced, which further decreases the Company's risk."[111]

Mr. Ruback further testified that UNS' proposal "is extreme because the proposed customer charges are intended to recover all of the proposed increase plus some of the margin recovered in existing volumetric rate."[112] It is not uncommon for utilities to propose increases in fixed charges to recover a disproportionate amount of the proposed revenue increase. But UNS Gas has gone much

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[103] Ex. S-23 (Ruback Direct) at 1.
[104] *Id.*
[105] *Id.*
[106] Ex. S-23 (Ruback Direct) at 3.
[107] *Id.*
[108] Ex. S-23 (Ruback Direct) at 4.
[109] *Id.*
[110] *Id.* at 6.
[111] *Id.*
[112] *Id.*

further in this case and has proposed to recover all of the proposed increase and some of the volumetric margin recovered in existing rates.[113]

The Company's proposal is also a step toward a Straight-Fixed-Variable rate design. Mr. Ruback testified as to the inappropriateness of such a rate design to retail gas distribution:

> The SFV pipeline rate design is not appropriate for retail distribution rate design because the theoretical underpinning of the SFV pipeline rate design does not apply to distribution service. FERC's SFV was implemented to ration pipeline design day capacity by price. The SFV method should not be applicable to distribution service because there is no need to ration retail distribution capacity. There is no need to ration UNS' distribution capacity since UNS has no distribution constraints and has not had to curtail distribution service over the last 5 years.[114]

Mr. Ruback further testified that based upon his experience, other jurisdictions allow for reasonable fixed customer charges and reasonable fixed demand charges, but require the bulk of the distribution revenue requirement to be recovered over throughput.[115]

Staff, on the other hand, considered cost of service, the desire to encourage energy conservation, the need to use gradualism, and other factors in determining an appropriate rate design for the Company.[116] Staff Witness Smith's Schedule RCS-S1 shows Staff's rate design calculations in this case.

Staff has proposed an across-the-board base rate revenue increase of 11.80%, excluding the Residential CARES class.[117] This is much lower that the average percent increase proposed by UNS Gas of 21.11.[118] For the Residential CARES rate, Staff proposed a revenue increase of 4.54% as opposed to the 21.11% increase proposed by the Company.[119]

Staff's proposed rate design also reflects a much more gradual approach to increasing customer charges, than the Company's proposal. Of the $4.962 million proposed base rate increase, approximately $2.560 million (52%) is collected through fixed charges. Under Staff's proposal, the

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[113] Ex. S-23(Ruback Direct) at 6.
[114] *Id.* at 9.
[115] Ex. S-23 (Ruback Direct) at p. 10.
[116] Ex. S-26 (Smith Supplemental Direct) at 2.
[117] *Id.* at 5.
[118] *Id.*
[119] Ex. S-26 (Smith Supplemental Direct) at 5.

residential customer charge would increase from $7.00 to $8.50.[120] Further, rather than a reduction in the per therm margin proposed by UNS Gas for residential customers, Staff's proposed rate design recommends that the distribution margin be set at $0.3217 per therm.[121]

Staff Witness Smith explains the impact of Staff's proposal on the average residential customer on page 9 of his Supplemental Direct Testimony:

> As shown on Attachment RCS-S2, page 1 of 10, an R-10 customer using 100 therms would see their total bill increase from $115.48 to $119.11, for an increase of $3.63 per month, or 3.14 percent. The corresponding increase in base rates only would be form $37.04 to $40.67, an increase of 9.80 percent per month. Bill impacts for a range of other monthly usage levels for residential customer (Rate R-10) are also presented on Attachment RCS-S2, page 1 of 10. As shown there, total bill increases at Staff's recommended rates range from 2.21 percent (at 500 therms) to 12.96 percent (at 5 therms). Base rate increases (excluding gas costs), range from 7.72 percent (at 500 therms) to 18.94 percent (at 5 therms). At average January usage of 87 therms per month, the proposed increase of $3.36 equates to a 3.31 percent increase in a residential customer's total monthly bill, or a 10.14 percent increase in the non-gas cost portion of the customer's bill.[122]

The impacts on the average bills of other customer classes are discussed on pages 9-13 of Staff Witness Smith's Supplemental Direct Testimony. Staff's proposed rate design is reasonable and should be adopted by the Commission.

## V. The Commission Should Reject the Company's Proposed Throughput Recovery Mechanism Which Would Shift Risk Normally Borne by the Company to Rate Payers.

UNS Gas has also proposed a new Throughput Recovery Mechanism ("TAM") in this proceeding. Staff Witness Steven Ruback explained how the Company's proposed TAM would be calculated in the following passage from his Direct Testimony:

> The TAM is calculated by first establishing a base UPC (usage per customer). The base UPC is calculated by the test year throughput divided by the test year average number of customers. This is then compared to the actual UPC which is calculated as the actual throughput divided by the actual number of customers in a calendar year. The difference between the base UPC and the actual UPC is then

[120] *Id.* at 6.
[121] *Id.* at 9.
[122] Ex. S-26 (Smith Supplemental Direct) at 9.

> multiplied by the test year's number of customers and the margin rate per therm to arrive at the required throughput adjustment in dollars. This dollar amount is then divided by the projected 12 month throughput ("therms") to arrive at the adjustment per therm.[123]

The TAM will either provide a credit or a surcharge to the existing customer's volumetric rate charge based on usage per customer.[124]

The Staff opposes the Company's proposed TAM for several reasons. First, Staff's expert testified that the type of costs traditionally recovered in an automatic adjustment clause such as a TAM are skyrocketing and volatile costs, not within the Company's control, which if not recovered in a timely manner, could jeopardize a utility's financial health.[125] The Company's proposed TAM does not meet this test.

> First, traditional rate making has not left the Company in poor financial health. Second, non-gas costs are relatively stable from year to year and certainly not volatile to the same extent as gas costs. Third, non-gas costs are within management's control.[126]

In addition, the Company already has several revenue decoupling mechanisms such as the TAM. One example is the customer charge, which is a fixed rate independent of throughput.[127] Another example is the PGA, which protects the Company from price hikes regardless of throughput.[128]

Few jurisdictions have approved the use of a TAM; and the TAM in those jurisdictions has been far different than the broad-based, all-inclusive TAM proposed by the Company in this case.[129]

This Commission rejected a similar proposal by Southwest Gas in Decision No. 68487.[130] The Commission, however, indicated that the Staff and stakeholders should continue to further examine the TAM to see if agreement could be reached on the mechanism's use and appropriateness in cases. The Staff is willing to undertake those discussions with stakeholders outside of this case to see if such agreement can be reached.

In summary, the Commission should reject the Company's proposed TAM because it:

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[123] Ex. S-26 (Ruback Direct) at 12-13.
[124] *Id.* at p. 12.
[125] *Id.*
[126] *Id.*
[127] Ex. S-26 (Ruback Direct) at p. 12.
[128] *Id.*
[129] TR
[130] Cite to Docket No. G-01551A-04-0876.

1) shifts the risk of declining usage attributable to weather and economics from UNS shareholders to ratepayers;

2) it constitutes piecemeal ratemaking; and

3) it would discourage retail customers from undertaking conservation.[131]

## VI. The Commission Should Find that the Company's Natural Gas Procurement Practices and Policies were Reasonable and Prudent during the Audit Review Period.

In Docket Number G-4202A-05-0831, Staff conducted a complete audit of the Company's natural gas procurement practices and policies. The audit review period was from September 2003 through December 2005.[132] The audit matter was filed on November 10, 2005. In a Procedural Order issued on September 8, 2006, Administrative Law Judge Dwight D. Nodes ("Judge Nodes") consolidated the audit with the other two dockets in the caption above.

Mr. Jerry E. Mendl, President of MSB Energy Associates, Inc. and Mr. George E. Wennerlyn, President of Select Energy Consulting, LLC, conducted the audit on behalf of Staff. Mr. Mendl issued six findings which are listed in his pre-filed Direct Testimony.[133] Staff requests that Mr. Mendl's findings be adopted by the Commission. In finding number one, Mr. Mendl found that the Company's procurement strategy and January 1, 2005 Price Stabilization Policy were prudent. At the hearing, Mr. Mendel specifically testified, "I concluded that the natural gas procurement strategy that was set forth in the price stabilization policy was reasonable over the review period."[134] Mr. Mendel's other five findings related to the Price Stabilization Policy. Those findings are discussed in part below.

In his pre-filed Direct Testimony, Mr. Wennerlyn made three conclusions based on his audit and analysis. The conclusions are equivalent to findings of fact. In conclusion number one, Mr. Wennerlyn concluded that the Company's purchases from September 2003 through December 2005 were reasonable and prudent.[135] Mr. Wennerlyn's other two conclusions were recommendations on a going forward basis. The recommendations are based on his audit and analysis of the Company's

[131] Ex. S-26 (Ruback Direct) at p. 19.
[132] TR Vol. IV at 761. See also Exhibit S-20 at 1, ll. 10-17.
[133] Exhibit S-20 at 1.
[134] TR Vol. IV at 761.
[135] Exhibit S-18 at 4.

current procurement practices. Staff requests the Commission to adopt Mr. Wennerlyn's three conclusions or findings of fact.

## VII. The Applicant's Gas Price Stabilization Policy Should not be Approved.

UNS Gas requests approval of its Gas Price Stabilization Policy in this proceeding. In his pre-filed Direct Testimony, Mr. David Hutchens explained the Company's request:

> We believe that instead of the Commission attempting to *second guess, after the fact*, the individual acts that UNS Gas transacted in connection with gas procurement and hedging, it is more productive and beneficial to customers that the Commission review the policies and approve them prospectively. That way the Company will know the clear direction of the Commission and act accordingly. If the Company acts within the approved policies, its transactions *will be conclusively prudent*.[136]

Staff urges the Commission to reject the Company's request. Approval of the hedging policy would insulate 45% of the Company's gas purchases from subsequent prudency reviews. Pre-approval is not necessary and could benefit the Company to the detriment of ratepayers.

UNS Gas witnesses attempt to dismiss Staff's concerns about pre-approval. In his Rebuttal Testimony, Mr. Hutchens argued that the policy "would not put the Company on 'autopilot.'"[137] He explained:

> In practice, the Company has been very active in changing its Policy to react to changing market conditions....The Company is committed to continuing to this level of detailed, active review of its purchasing strategies whether or not the Policy is approved by the Commission.[138]

Notwithstanding Mr. Hutchens' explanation, he also stated that, "It *would not be acceptable for the Company to implement a procurement policy that could later be second-guessed* due to something as vague as 'changes in market conditions.'"

At hearing, UNS Gas President Mr. James S. Pignatelli explained the Company's view of 'second-guessing.' Mr. Pignatelli first stated that, "It's just my opinion, in the heat of a rate case three or four years after the fact the circumstances extant when the transaction was entered into are

[136] Exhibit UNSG-4 at 7(emphasis added). Mr. Pignatelli may have made a minor concession at hearing. Mr. Pignatelli stated that, "if you follow [the Gas Price Stabilization Policy], you should be *presumptively prudent*." TR Vol. I at 122.
[137] Exhibit UNSG-5 at 10.
[138] *Id.*

forgotten."[139] He then stated that, "The [C]ompany would always keep adequate documentation. But in the heat [of a procurement review], I get afraid of *some political decision* down the road."[140]

Instead of a typical prudence review, the Company requests a "compliance review." A compliance review would be limited to "whether or not you're compliant with making the purchases at the right volume and at the right times."[141] The Company also argues that upfront approval allows stakeholders to review and comment on a hedging policy prior to implementation. It claims that prior stakeholder input is preferable to after-the-fact prudency reviews.[142]

The Company and Staff have a fundamental disagreement on the purposes of a hedging plan. UNS Gas believes that the only purpose of a hedging policy is reducing volatility of natural gas prices.[143] Mr. Hutchens specifically testified that the purpose of the Gas Stabilization Policy is to "reduce the volatility of the overall price."[144] He also stated that savings to customers is not one of the purposes of the policy.[145] Mr. Hutchens explained that the Company's policy is a "dollar cost averaging approach." Mr. Hutchens believes that prices for hedged volumes have a 50/50 chance of being "above or below market."[146]

Staff's position is more complex than the Company's position. Mr. Wennerlyn explained Staff's view of hedging policies:

> I think there are three legs to the milk stool, and I think they all carry equal value. And you have [1] the stability [of prices], [2] the reliability [of physical supplies] and [3] the competitiveness, in other words, the *potential to get the lowest possible cost*.[147]

Mr. Wennerlyn acknowledged that a cost premium necessary to achieve stability may be considered prudent.[148] He also testified that under some market conditions hedged prices could be prudent and

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[139] TR Vol. I at 106. See also *Id.* at 121.
[140] TR Vol. I at 122-123 (emphasis added).
[141] *Id.* at 157.
[142] *Id.* at 133-134. See also *Id.* at 137.
[143] *Id.* at 129; and 157. See also Exhibit UNSG-4 at 5-6.
[144] TR Vol. I at 129.
[145] *Id.*
[146] *Id.*
[147] TR Vol. IV at 744-745(emphasis added). See also *Id.* at 736.
[148] *Id.* at 752-755.

above market.[149] But costs and the level of stability achieved must be reviewed in the context of all relevant factors.

Moreover, the third prong of Mr. Wennerlyn's analysis is not second-guessing. Mr. Pignatelli conceded that the Company "would always attempt to get the lowest possible price."[150] The third prong is necessary to determine whether actual purchases were made at *competitive* prices. Mr. Wennerlyn acknowledged that the goals of low prices and stable prices may conflict at times.[151] Above market prices for hedged volumes do not automatically result in disallowances. The ultimate goal is to evaluate all relevant factors and appropriately balance all information flowing from the analysis.

Eliminating traditional prudency reviews would prevent Staff from using its three-prong review of hedging plans. The Company's "compliance" review would limit Staff's evaluation to the volumes purchased and the timing of purchases under the plan. If the Company followed the plan, it would be deemed "conclusively" or "presumptively" prudent.

Mr. Mendel testified that one of the reasons for a full prudence review is that the Company has discretion under its policy.[152] Mr. Mendel expressed concern about the "higher burden of proof [for Staff] to prove [a purchase] wasn't prudent." A "compliance" review could insulate the Company for its discretionary purchases. Therefore, the Company may not receive a disallowance even if exercise of its discretion was imprudent.

For example, "a utility could be operating on the basis of sticking to a plan even though it was no longer prudent based on the [market] conditions that occurred at [the time of a purchase]."[153] If the Company didn't keep adequate documentation about market conditions, Staff may not meet the higher burden of proof. The Commission should not approve a plan that would shift the burden of proof to Staff when the Company is responsible for maintaining the evidence.

The Company appears concerned that future prudence reviews could use different "metrics." Mr. Hutchens testified:

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[149] *Id.*
[150] TR Vol. I at 104.
[151] TR Vol. IV at 751.
[152] *Id.* at 768.
[153] *Id.* at 772.

> ....there's a lot of different ways that you can evaluate hedging policies. I mean, there's - - I think [Staff consultants] must have done five or six themselves, and we could probably do another five or six. And anyone you could throw that question out to could probably provide different metrics on whether or not that would be deemed prudent.[154]

Mr. Hutchens merely states the obvious.

Accounting and economic theory and practice are subject to change. For example, methodologies for determining cost-of-capital are debated in every rate case. Purchases under a hedging plan should not be afforded special ratemaking treatment. Other expenses are not automatically accepted merely because theories change on what is considered a prudent and allowable expense.

Most importantly, conducting a "compliance" review in place of a prudence review would shield the Company from risk. Mr. Hutches testified, "I think what we're trying to get at is a surety."[155] Mr. Hutchens explained that a "prudence review [would bring] into question the price. That's the thing that we're trying to avoid."[156] Judge Nodes asked if insulation from risk could "provide a disincentive for the company personnel who are responsible for those purchasing practices to make informed and wise decisions."[157] Mr. Hutchens responded, "[T]hat's an appearance hurdle that I can't argue away."[158]

A compliance review is also a one-way street because ratepayers would not benefit from a less rigorous review. Mr. Mendel addressed the issue with Judge Nodes:

> ACALJ Nodes: Mr. Mendel, is there any advantage to the Commission and/or the Company's customers in approving, if the price stabilization policy were to be approved by the Commission, or are the only benefits that accrue from Commission approval of such a policy only to the Company?
>
> Mr. Mendel: [O]nly to the Company. I can't think of any reason....that a Commission approval of that approach versus nonapproval of that approach

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[154] *Id.* at 137.
[155] *Id.* at 137.
[156] *Id.* at 156-157.
[157] *Id.* at 138.
[158] *Id.* at 138-139.

> would make any difference in the ratepayer's perspective, *at least a favorable difference.*[159]

Mr. Mendel also agreed with Judge Nodes that approval is intended to insulate the Company from future risk.[160]

Finally, the evidence demonstrates that pre-approval is simply not necessary. The Company did not identify a single valid reason for pre-approval. Mr. Mendel described the regulatory standard for reviewing gas purchases. He testified "that prudency has to be judged in the context of what was known at the time decisions were being made. And I believe that that is a fairly standard view among regulatory agencies."[161] Pre-approval would change the above standard. The Company did not provide any evidence that this standard is unfair.

Instead, the Company argued that future Staff personnel, and future Commissions, may second-guess the Company's decisions. Mr. Hutchens testified,

> Mr. Gray might not be sitting there [three years after a purchase]. I might not be sitting here. I don't know who else would be looking at this, and that's where we're trying to get protection.[162]

Mr. Hutchens also criticized Mr. Mendel's pre-filed direct testimony. Mr. Mendel testified, "Changes in market conditions would invalidate the approval."[163] Mr. Hutchens claims that Mr. Mendel's testimony "is exactly the type of vague hindsight review that the Company is trying to avoid with Commission approval of its Policy."[164] Mr. Pignatelli expressed concern that future Commissions could make "some political decision down the road."[165]

Yet both witnesses testified that they have not experienced any problems in Arizona. Mr. Pignatelli testified that he experienced "political decisions" in California, not Arizona.[166] He also stated, "I have not seen any evidence of this concern. I think Staff is handling their prudence very fairly and appropriately."[167] Mr. Hutchens concurred with Mr. Pignatelli.[168]

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159 TR Vol. IV at 778.
160 *Id.*
161 *Id.* at 772.
162 TR Vol. I at 139.
163 Exhibit S-21 at 24.
164 Exhibit UNSG-5 at 11.
165 TR Vol. I at 122.
166 *Id.* at 123.
167 *Id.* at 121.
168 *Id.* at 140. See also *Id.* at 139 ("up to this point we've been fine with it."); and 138 ("I would guess that I probably would be pretty confident based on the way that Staff has analyzed it and their outside consultants, I would be.").

Nevertheless, the Company argues that pre-approval is necessary and fair to get "upfront" stakeholder input. Staff agrees that prior stakeholder input on hedging policies is a good idea. But this process is already being used. And the Company could not provide any evidence that it would be discontinued in the future. Mr. Hutchens could not identify any example of Staff not providing "upfront" feedback on the Company's hedging policies.[169]

Pre-approval is not necessary because the Company can protect itself by keeping adequate documentation. Mr. Pignatelli testified, "My concern is, though, when you're buying a commodity that moves hourly or every 15 minutes, that when you go back and retroactive[ly] look at it, you might lose sight of what the actual situation was at the time that was being purchased."[170] He further explained that a prudence review may "not fully take into consideration everything that was going on at the time."[171] But Mr. Pignatelli conceded that adequate documentation could demonstrate the circumstances occurring when a purchase was made.[172] Mr. Hutchens also conceded the point.[173]

Staff respectfully asks the Commission to reject the Company's request to approve its Gas Price Stabilization Policy. Pre-approval would shift the burden of proof to Staff, and limit the issues that could be reviewed. UNS Gas does not need pre-approval to obtain upfront stakeholder input. The Company did not provide any evidence that pre-approval is necessary or that the current review standard is unfair. Therefore, the request is unsupported by the evidence. Furthermore, pre-approval would benefit the Company without providing offsetting benefits to ratepayers. Pre-approval is not in the public interest.

## VIII. Staff's Recommendations for the Purchased Gas Adjustor are Reasonable, Consistent with a Policy of Gradualism, and Should be Adopted by the Commission.

The Company filed an application to modify its purchased gas adjustor ("PGA") on January 10. 2006. The docket was consolidated with the other two captioned proceedings on September 8, 2006. In his Direct Testimony, Mr. Gray offered seven recommendations for the PGA mechanism. Staff respectfully requests the Commission adopt all of his recommendations. Other than the

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[169] *Id.* at 158.
[170] *Id.* at 121-122.
[171] *Id.* at 122.
[172] *Id.* at 122.
[173] *Id.* at 136-137.

bandwidth and interest rates, the Company appears to accept Mr. Gray's remaining recommendations.[174]

Staff and the Company agree that the bandwidth for the purchased gas adjustor ("PGA") should be modified in this proceeding. The current bandwidth for UNS Gas is $0.10 per therm. The current bandwidth was set for all Arizona local distribution companies ("LDCs") in Decision No. 62994 on November 3, 2000.[175]

In February 2006, the Commission changed Southwest Gas' bandwidth to $0.13 per therm in the company's most recent rate case.[176] In March 2006, the Commission changed Duncan Rural Services' bandwidth in its most recent rate case. The Commission allowed the company to change its PGA rate by $0.10 per month or up to $1.20 per year. The Commission provided extraordinary relief to Duncan Rural Services because of its small size and financial distress.[177]

Staff witness Mr. Bob Gray recommends increasing UNS Gas' bandwidth to $0.15 in this proceeding.[178] Mr. Gray explained his recommendation:

> Staff is cognizant of UNS' desire for greater flexibility in the PGA bandwidth as well as the need for some amount of checks and balances in how gas costs are passed on to customers, particularly in times when gas prices are high and volatile....A $0.15 per therm PGA bandwidth provides significant additional room for movement of the monthly PGA rate, while still providing a reasonable limit on the exposure of UNS' customers to an automatic adjustment without Commission review. Staff believes that a $0.15 per therm bandwidth reasonably balances Company and customer interests.[179]

At the hearing, Mr. Gray explained that the PGA bandwidth must balance a number of policy goals.

The goals include "the Company's ability to recover their gas costs, trying to provide some cushion to ratepayers, [and] providing the Commission an opportunity to review large changes in

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[174] See e.g. Exhibit UNSG-5 at 4-5.
[175] Exhibit S-41 at 5-6.
[176] *Id.* at 6.
[177] *Id.*
[178] *Id.* at 7.
[179] *Id.* at 7-8.

rates before they go into effect."[180] Mr. Gray also acknowledged that a bandwidth could result in a company "accumulating large bank balances that ultimately must be paid by future customers."[181]

The Company originally proposed eliminating the bandwidth or expanding it to $0.25.[182] In his Rebuttal Testimony, Mr. Hutchens agreed to $0.20 per therm as proposed by the Residential Utility Consumers Office ("RUCO").[183] The Company's primary complaint about the bandwidth is that the mechanism dampens the price signal to customers.[184]

Staff agrees that the policy goals cited by the Company should be considered. But the Commission must still balance multiple policy goals. Staff's proposal is intended to be "a more gradual approach, with the Commission, Staff, RUCO, and other parties assessing the impacts of a move to a $0.15 per therm PGA bandwidth before possibly considering a larger change in future proceedings."[185] Staff's recommended change appropriately balances competing policy goals in this proceeding. Staff respectfully requests the Commission to adopt its recommendation of a $0.15 per therm PGA bandwidth.

In addition to the change in bandwidth, the Company asks the Commission to dramatically change the interest rate on PGA bank balances. The Company seeks a two-tiered interest rate. It requests the London Interbank Offered Rate ("LIBOR") plus 1.5% for balances up to twice the PGA bank balance threshold.[186] Mr. Hutchens states that the requested interest rate is equivalent to "UNS Gas' actual cost of new debt."[187] He testified that, "Under its revolving credit facility, UNS Gas pays interest at a rate of LIBOR plus a credit spread of 1.5%."[188] Mr. Hutchens subsequently revised the Company's request to LIBOR plus 1.0%.[189]

Above the base level, the Company requests its "authorized weighted average cost of capital as determined in this proceeding."[190] Mr. Hutchens argues that high bank balances cannot be

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[180] TR Vol. VII at 1130-1131.
[181] *Id.* at 1133.
[182] Exhibit UNSG-4 at 11-12.
[183] Exhibit UNSG-5 at 4.
[184] TR Vol. I at 130-131.
[185] Exhibit S-42 at 2-3.
[186] Exhibit UNSG-4 at 12.
[187] *Id.*
[188] *Id.* at 13.
[189] Exhibit UNSG-5 at 5.
[190] Exhibit UNSG-4 at 14.

considered a short term asset on the Company's balance sheet. He testified that high bank balances require longer-term investment capital in the form of working capital.[191] The Company also requests long-term debt required for bank balances be excluded from its capital structure.[192]

Staff opposes all of the Company's proposed changes for interest on bank balances. Interest rates were originally set in a generic docket and applied uniformly to all Arizona LDCs.[193] Interest rates were then modified in another generic docket. UNS Gas' current interest rate is "the monthly three month commercial financial paper rate published by the Federal Reserve."[194] The rate was approved in Decision No. 68600 on March 23, 2006. Mr. Gray testified that there are no compelling reasons for changing UNS Gas' interest rate.[195]

Notwithstanding his testimony at the hearing, Mr. Gray offered an alternative in his Direct Testimony. Mr. Gray discussed recent decisions in which the Commission approved different interest rates. In the most recent rate case for Southwest Gas (Decision No. 68487, dated February 23, 2006), the Commission approved use of "the one-year nominal Treasury constant maturities rate.[196] The Commission has also approved the same rate for Arizona Public Service ("APS").[197] Mr. Gray stated that Staff would not be opposed to this rate as an alternative to retaining the existing rate.[198]

UNS Gas did not present sufficient evidence demonstrating that its financial situation differs substantially from Southwest Gas or APS.[199] Mr. Gray also testified that the Commission has never used a utility's cost of borrowing to determine interest rates on bank balances.[200] He explained that interest rates higher than those previously approved could be a disincentive to a utility. In other words, the utility may not timely seek approval to reduce bank balances.[201]

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[191] *Id.*
[192] *Id.* at 15.
[193] Exhibit S-41 at 13.
[194] *Id.*
[195] TR Vol. VII at 1131.
[196] Exhibit S-41 at 15.
[197] *Id.*
[198] *Id.* at 16.
[199] *Id.* at 15.
[200] *Id.* at 15.
[201] *Id.* at 15-16.

## IX. The Commission Should Adopt Staff's Recommendations For UNS Gas' Low-Income Assistance Programs and Proposed DSM Programs; The Commission Should Not Approve Exhibit UNSG-23 in this Proceeding; and the Commission Should not Approve the Baseline Study and Include a Portion of the Costs in this Proceeding.

Staff witness Ms. Julie McNeely-Kirwan reviewed the Company's low-income assistance programs and proposed demand-side management ("DSM") programs. Ms. McNeely-Kirwan provided eleven recommendations in her direct testimony.[202] Staff respectfully requests that the Commission adopt Staff's eleven recommendations, with the following modifications: (i) with respect to the initial amount to be recovered through the DSM adjustor, Staff recommends a per-therm DSM charge of $0.0025, to recover the cost of the low-income weatherization program and one quarter of the proposed budget for the remaining DSM program; and (ii) with respect to deadlines applicable to the DSM adjustor, Staff recommends that the UNS DSM adjustor reset filing be done on April 1, of each year, and that the annual adjustment be done on June 1 of each year. In addition, Staff recommends that, since the Staff-recommended CARES discount is already included in the rate design, that the $441, 511 CARES discount proposed by UNS be removed from Operating Expenses.

Staff also requests that the Commission not approve UNG Gas Exhibit UNSG-23 in this proceeding. Staff asks the Commission to follow the same procedures for approval of UNS Gas' DSM programs as it as used for other utilities.[203]

Finally, the Commission should not approve a baseline study in this proceeding. Furthermore, it should not include a portion of the costs in the DSM adjustor. Both decisions should be part of a separate application to the Commission.

In recommendation number four, Staff recommended the following: "UNS Gas should submit detailed DSM program proposals to the Commission as soon as possible, rather than waiting for the conclusion of the UNS Electric rate case."[204] On March 23, 2007, Company witness Ms. Dennis A. Smith filed a supplemental exhibit to her Rebuttal Testimony (Exhibit DAS-3).[205] In the filing, Ms. Smith stated, "This supplemental exhibit contains UNS Gas' proposed Demand-Side Management

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[202] See Exhibit S-39 at 31-32. Note that Ms. NcNeely-Kirwan's recommendation to maintain the currently monthly customer charge for CARES customers is also addressed in the rate design section of this brief.

[203] See e.g. the process used for Southwest Gas in its most recent rate case (Decision No. 68487, dated February 23, 2006).

[204] Exhibit S-39 at 31.

[205] At the hearing, the Company marked DAS-3 as UNSG-23. TR Vol. III at 517.

("DSM") portfolio and *is being filed for informational purposes* so that Staff and others may better evaluate UNS Gas' DSM programs in detail."[206]

At the hearing, Ms. Smith changed the Company's request regarding the filing. Ms. Smith testified, "UNS Gas would prefer to have the Commission approve the DSM program portfolio *in this case* so long as a decision in other matters is not affected by this program portfolio decision."[207] Ms. NcNeely-Kirwan testified that the DSM portfolio should be submitted as a separate application.

She explained:

> The portfolio plan should be filed as part of a separate application for approval so Staff can review the plan in detail and submit and review data requests and perform its own cost effectiveness evaluation.[208]

Ms. McNeely-Kirwan testified that review under a separate application is the Commission's routine practice.[209] Ms. Smith also conceded the issue in her testimony at the hearing.[210]

The Company appears to accept all of Staff's recommendations. Nevertheless, the Company discussed its concern about some of the recommendations. For example, Ms. Smith argued that the Societal Cost Test should not be the only cost-effectiveness test used to evaluate the portfolio.[211] Ms. McNeely-Kirwan testified that the Company could provide the results of other cost-effectiveness tests. But at this time, Staff's position is that "the societal cost test is the best way of evaluating the cost effectiveness of the DSM program."[212]

In her rejoinder testimony, Ms. Smith requested that $82,000 of the costs of a baseline study be included in the DSM adjustor in this proceeding.[213] She also requested that the baseline study be approved in this proceeding.[214] Staff opposes both requests.

Ms. McNeely-Kirwan testified that the costs of the baseline study could include costs for UNS Electric and Tucson Electric Power ("TEP").[215] She further testified that the no portion of the costs

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[206] Exhibit UNSG-23 at 1 (emphasis added).
[207] TR Vol. III at 518.
[208] TR Vol. VII at 1141.
[209] *Id.* at 1141.
[210] TR Vol. III at 597.
[211] See e.g. UNSG-22 at 2-3.
[212] TR Vol. VII at 1143. See also *Id.* at 1149.
[213] Exhibit UNSG-21 at 2.
[214] *Id.*
[215] TR Vol. VII at 1142-1143.

for a baseline study should be approved in this proceeding. The study and its costs should be submitted as part of the separate application.[216]

## X. Conclusion

UNS Gas' application for a rate increase should be granted to the extent discussed in Staff's testimony in this Docket. The Commission should reject the Company's proposed rate design and TAM and other proposals which are designed to shift an abnormally high degree of risk away from the Company to rate payers.

RESPECTFULLY SUBMITTED this 5th day of June 2007.

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[216] *Id.* See also *Id.* at 1151, line 24 to 1152, line 18.

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